Financial Reporting Council

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Submitted by email

20 May 2020

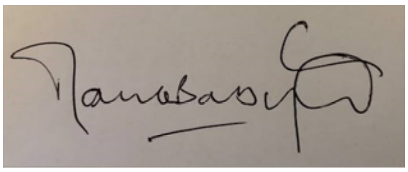
Dear Jean-Paul

IASB Exposure Draft ED/2020/1 *Interest Rate Benchmark Reform—Phase 2 Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16*

Enclosed in this letter is the response of the UK Financial Reporting Council to the IASB's ED/2020/1 *Interest Rate Benchmark Reform—Phase 2 Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16.*

If you would like to discuss our comments, please contact me or Susanne Pust Shah on s.pustshah@frc.org.uk.

Yours sincerely



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Financial Reporting Council

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Submitted electronically

18 May 2020

Dear Board Members

Exposure Draft ED/2020/1 *Interest Rate Benchmark Reform—Phase 2 Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16*

I am writing on behalf of the UK Financial Reporting Council (FRC) to provide comments on Exposure Draft (ED) ED/2020/1.

As you will be aware, part of the UK's preparations for exiting the European Union is that the Department for Business, Energy and Industrial Strategy (BEIS) is in the process of setting up the UK Accounting Standards Endorsement Board (UK EB) to endorse International Accounting Standards for use in the UK. Until the EB is established, the BEIS Secretary of State will consider the adoption of any standards or amendments to standards. To facilitate this, BEIS has requested assistance from the FRC in undertaking activities relating to UK endorsement. The views expressed by the FRC in this letter are separate from and will not necessarily affect the conclusions in any endorsement assessment provided to the Secretary of State on a new or amended International Accounting Standard.

Our outreach with UK stakeholders confirm that the proposed amendments should achieve their objective of providing useful information about the effects of the benchmark rate reforms, although they have also identified targeted improvements to the ED. Stakeholders commended the IASB's efforts to produce timely proposals and reiterated the urgency of the amendments, given the deadlines for the completion of the reforms.

We also welcome the proposed Phase 2 amendments, as we believe they are designed to portray the real economic consequences of the reform. That said, we highlight below a few areas where we believe clarification or limited change could be beneficial, either in the text of the standard itself or within the Basis for Conclusions. Nevertheless, in our view timely completion of the proposals is paramount and should not be held up by finding alternative solutions.

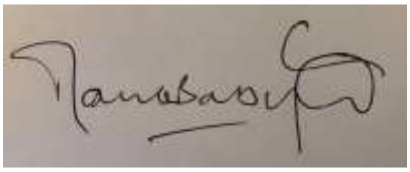
We also wish to stress that although we generally agree with the proposals on modifications, our agreement is ringfenced to these specific proposals. Based on feedback from stakeholders it will be necessary to have a wider debate about the merits of extending the definition of modifications used for the purpose of the proposals in this ED, to changes outside of benchmark rate reforms.

We support the IASB's decision not to make amendments to IFRS 17 or IFRS 13 for consequences of the benchmark rate reforms.

Our detailed responses to the questions are included in the Appendix to this letter.

If you would like to discuss these comments, please contact me or Susanne Pust Shah (s.pustshah@frc.org.uk).

Yours sincerely



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Appendix: Questions

Question 1— Modifications of financial assets and financial liabilities (paragraphs 6.9.1–6.9.6 of the [Draft] amendments to IFRS 9, paragraphs 20R–20S and 50–51 of the [Draft] amendments to IFRS 4 and paragraphs 104–106 and C1A–C1B of the [Draft] amendments to IFRS 16)
Paragraphs 6.9.2–6.9.6 of the draft amendments to IFRS 9 propose that: (a) a financial asset or financial liability would be modified if the basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument. In this context, a modification can arise even if the contractual terms of the financial instrument are not amended. (b) an entity would apply paragraph B5.4.5 of IFRS 9 as a practical expedient to account for a modification of a financial asset or financial liability that is required by interest rate benchmark reform. (c) a modification is required by interest rate benchmark reform if and only if (i) it is required as a direct consequence of interest rate benchmark reform; and (ii) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (i.e. the basis immediately preceding the modification). (d) an entity would also apply the practical expedient proposed in paragraph 6.9.3 if an existing contractual term is activated that results in a change in the basis for determining the contractual cash flows of a financial asset or a financial liability, and particular other conditions are met. Paragraphs BC10–BC36 of the Basis for Conclusions describe the Board's reasons for these proposals. (e) The Exposure Draft proposes to make corresponding amendments to IFRS 4 that would require insurers applying the temporary exemption from IFRS 9 to apply the same practical expedient as described above. (f) The Exposure Draft proposes amendments to IFRS 16 that would require entities to apply paragraph 42 of IFRS 16 to account for a lease modification that is required by interest rate benchmark reform. Paragraphs BC39–BC41 and paragraphs BC118–BC125 of the Basis for Conclusions describe the Board's reasons for these proposals. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

A1 We agree that the relief should equally apply to financial instruments that are modified and those that have existing contractual terms activated, as proposed in paragraphs 6.9.1, 6.9.2 and 6.9.5 of IFRS 9 in the ED. We also support the proposed practical expedient to apply paragraph B5.4.5 of IFRS 9 to these changes.

A2 To clarify that the reliefs in proposed paragraphs 6.9.1 to 6.9.6 of IFRS 9 apply in the context of amortised cost measurement, we suggest the repositioning of these paragraphs in Section 5.4 *Amortised Cost Measurement* of IFRS 9.

A3 We concur with the proposed conditions applicable to modifications and activations in paragraph 6.9.3 and 6.9.5 of IFRS 9 in the ED, respectively. We would suggest a couple of drafting changes. Firstly, paragraph 6.9.3(a) should be amended to "the modification is <u>necessary</u>", and paragraph 6.9.5(b) should refer to the activation being "<u>triggered</u> as a direct consequence of interest benchmark reform", instead of stating that such changes are required. We believe although the reform of benchmark indices is a requirement, a modification or activation in contracts to affect the new benchmarks, may not always be required under law, regulation or existing contractual terms.

A4 Paragraph 6.9.6 of IFRS 9 in the ED sets out the proposed order of accounting for changes to financial instruments made as a direct consequence of the reform and other additional changes. We generally concur with the proposals, although there appears to be an inconsistency with the related explanations in BC35 of the ED, as far as derecognition is concerned. BC35 seems to suggest that the financial instrument is assessed for derecognition first, if there are changes other than those required as a direct consequence of the reform. Paragraph 6.9.6, however, requires this step to be performed last. We do not necessarily believe the sequence would result in a different accounting outcome, but for ease of application, we suggest the IASB redrafts paragraph BC35 so it is clearly consistent with paragraph 6.9.6.

A5 As set out above we are supportive of the proposed amendments, including the proposal around what constitutes a modification. However, our agreement is ringfenced to these narrow amendments for benchmark reform. We acknowledge the IASB's intent to explore if there is diversity in practice on the application of the modification requirements in IFRS 9 in situations where the bases for calculating reference rates and other variables have been changed, and its desire to clarify or extend the scope of "modifications". However, we urge the IASB that any such work is part of a project which allows more time for a wider debate and stakeholder input and not to assume that agreement with these proposals is tacit support from stakeholders for broader amendments.

A6 We concur with the proposed amendments to IFRS 4. We have heard concerns from stakeholders who, under IFRS 4 have delayed the application of IFRS 9. They were seeking clarity that by applying the reliefs proposed in IFRS 4, they are not deemed to adopt IFRS 9. We do not believe that this is the intent and the IASB may wish to consider making an explicit statement to that effect.

A7 Proposed paragraph 106 of IFRS 16 states that if in addition to changes required by the interest rate benchmark reform other modifications are made, all modifications are accounted for as lease modifications. We considered unintended consequences of this proposal for COVID-19 related rent concessions. We understand that in a situation where a lessee makes changes for COVID-19 related rent concessions as well as modifications required by benchmark rate reforms, a lessee applying the relief in ED/2020/2 *Covid-19-Related Rent Concessions*, remains eligible for the relief proposed in paragraph 105 of IFRS 16 in this ED. On that basis, we concur with the proposed amendments to IFRS 16.

Question 2 — Amendments to hedging relationships (paragraphs 6.9.7–6.9.10 of the [Draft] amendments to IFRS 9 and paragraphs 102O–102R of the [Draft] amendments to IAS 39)
Paragraphs 6.9.7–6.9.10 of the draft amendments to IFRS 9 and paragraphs 102O–102R of the draft amendment to IAS 39 propose that an entity would amend the formal designation of the hedging relationship only to make one or more of the changes specified in paragraph 6.9.7 and paragraph 102O as and when uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. Paragraphs BC42–BC50 of the Basis for Conclusions describe the Board's reasons for these proposals. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose instead and why.

A8 We generally agree with the proposals in these paragraphs. Nevertheless, we heard some concern from stakeholders about restricting the permitted amendments to references to the new benchmark rate. It was suggested that other changes, including those specifically permitted in proposed paragraph 6.9.4 of IFRS 9 in the ED, may also be necessary changes for new hedge designations, and should be permitted. We request the IASB to explore whether more flexibility could be granted.

Question 3 — Accounting for qualifying hedging relationships and groups of items (paragraphs 6.9.11–6.9.15 of the [Draft] amendments to IFRS 9 and paragraphs 102S–102X of the [Draft] amendments to IAS 39)

Paragraphs 6.9.11–6.9.15 of the draft amendments to IFRS 9 and paragraphs 102S–102X of the draft amendments to IAS 39 propose that:

(a) the requirements in IFRS 9 and IAS 39 would be applied when the designation of a hedging relationship is amended to remeasure the hedging instrument and the hedged item based on the alternative benchmark rate and recognise any resulting ineffectiveness in profit or loss.

(b) the amount accumulated in the cash flow hedge reserve at the date the entity amends the description of the hedged item would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

(c) when there is a change in the basis for determining the contractual cash flows of a financial asset or a financial liability previously designated as a hedged item in a hedging relationship that has been discontinued, the amount accumulated in the cash flow hedge reserve for the discontinued hedging relationship would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

(d) when applying paragraph 6.9.7 or paragraph 102O to groups of items designated as hedged items, the hedged items would be allocated to sub-groups within the same hedging relationship based on the benchmark rate to which they are referenced and that the proportionality test would be applied to each sub-group separately.

(e) for the purpose of assessing retrospective effectiveness as required by IAS 39, the cumulative fair value changes of the hedged item and hedging instrument would be reset to zero when paragraph 102G of IAS 39 ceases to apply.

Paragraphs BC51–BC79 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

A9 There has been some debate about how the requirements in paragraphs 6.911 and 6.9.12 of IFRS 9 and paragraphs 102T and 102U of IAS 39 in the ED should be read. We believe that these paragraphs require remeasurement of the hedging instrument when the designation of the hedging instrument has been changed and remeasurement of the hedged item when the designation of the hedged item and the hedged risk has been changed. This is consistent with the Board's intention that hedge ineffectiveness is recorded in profit or loss.

A10 Nevertheless, paragraph BC63 of the ED may be interpreted as requiring that both the hedged item and the hedging instrument are remeasured at the same time, based on the new benchmark rate on an "as if" basis. Such an interpretation would imply that both the hedging instrument <u>and</u> the hedged item are remeasured on the new basis, regardless of whether the designation for both the hedging instrument <u>and</u> hedged item has been changed. We concur with the Board that ineffectiveness should be recorded in profit or loss and therefore recommend that the final requirements and Basis of

Conclusion are clarified to ensure alignment with our understanding of the proposed requirements.

A11 Such a clarification might focus, in part, on the wording in paragraph 6.9.10 of IFRS 9 and paragraph 102R of IAS 39 in this ED and in particular, the following clause from the second sentence: "an entity shall apply paragraphs 6.9.11 to 6.9.17 (102S-102Z) to the extent relevant" [proposed additions underlined]. We interpret this as stating that each leg of, for example, a fair value hedge is only remeasured using an alternative benchmark rate when that leg has been modified. If this is correct, then clarification could be provided by, for example, inserting explanatory parentheses such as, "to the extent relevant (i.e. to the extent hedged items and hedging instruments have been individually modified)."

A12 We concur with the relief for hedges of groups of items-hedges in paragraph 6.9.15 of IFRS 9 and paragraph 102X of IAS 39 in the ED. Stakeholders noted practical challenges with making the requirements operational, however since there is no simpler alternative which can maintain robustness of the hedge accounting requirements, we agree with the proposal.

A13 Paragraph 102S of IAS 39 in the ED provides relief in respect of the retrospective effectiveness testing by requiring that the cumulative fair value changes on the hedged item and hedging instrument are reset to zero. Stakeholders, however, would prefer an option over whether to retain the cumulative fair value changes or reset them to zero. They suggested that the option should be irrevocable and apply to all hedging relationships. We support this recommendation, as it could avoid unnecessary discontinuation of hedge accounting and ensures rigour in the application of an option.

Question 4 — Designation of risk components and portions (paragraphs 6.9.16–6.9.18 of the [Draft] amendments to IFRS 9 and paragraphs 102Y–102Z1 of the [Draft] amendments to IAS 39)
Paragraphs 6.9.16–6.9.18 of the draft amendments to IFRS 9 and paragraphs 102Y–102Z1 of the draft amendments to IAS 39 propose that: (a) an alternative benchmark rate designated as a non-contractually specified risk component that is not separately identifiable at the date it is designated, would be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within a period of 24 months from the date the alternative benchmark rate is designated as a risk component. (b) if subsequently, an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months from the date it was designated as a risk component, an entity would cease applying the requirement in paragraph 6.9.16 and paragraph 102Y and discontinue hedge accounting prospectively from the date of that reassessment. Paragraphs BC87–BC97 of the Basis for Conclusions describe the Board's reasons for these proposals. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

A14 Although we believe the proposals provide a pragmatic solution for existing and new hedging relationships, we recommend the IASB reviews the wording in the Basis for Conclusion to avoid implying that existing requirements in IAS 39 concerning non-contractually specified risk components are being expanded beyond the words in that standard.

A15 In particular we suggest the review of paragraph BC88 of the ED which concludes that the IFRS 9 and IAS 39 requirements are very similar and paragraphs BC87, BC89 and BC94 of the ED, which make reference to market liquidity and volume of trades. The explanations in these paragraphs are seen by stakeholders as inadvertently setting new de minimis criteria for all assessments of the separate identifiability criterion under IAS 39.

Question 5 — Effective date and transition (paragraphs 7.1.9 and 7.2.36–7.2.38 of the [Draft] amendments to IFRS 9 and paragraphs 108H–108J of the [Draft] amendments to IAS 39)

(a) The Exposure Draft proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2021. Earlier application would be permitted.

(b) The Exposure Draft proposes that the amendments would be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified in (ii) below. An entity would:

   (i) reinstate a discontinued hedging relationship if and only if the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, therefore, the entity would not have been required to discontinue that hedging relationship if the amendments had been applied at that time.

   (ii) not be required to restate prior periods to reflect the application of these amendments. However, the entity may restate prior periods if, and only if, it is possible without the use of hindsight.

Paragraphs BC110–BC115 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

A16 We heard concerns around the requirements for reinstatement of discontinued hedges, as proposed in paragraph 7.2.37 of IFRS 9 and paragraph 108I of IAS 39 in the ED. Entities, especially those subject to prudential regulations, could be required or may choose to close out or de-designate hedging instruments immediately after hedge accounting has failed. In this situation it would be problematic or even impossible to reinstate discontinued hedging relationships. The implications for new hedging relationships which include the de-designated hedging instrument are also not clear. To avoid these complications, stakeholders suggested an option over the restatement of failed hedging relationships. This option should be applied consistently to all hedging relationships that failed hedge accounting, because the amendments were not yet available. We support these recommendations and would request the IASB to consider them before finalising the amendments.

A17 We concur with the remainder of the effective date and transition proposals.

Question 5 — Disclosures (paragraphs 24I–24J and paragraphs 44HH–44II of [Draft] amendments to IFRS 7)
The Exposure Draft proposes that entities provide specific disclosures in order to provide information about: (a) the nature and extent of risks arising from interest rate benchmark reform to which the entity is exposed, and how it manages those risks; and (b) the entity's progress in completing the transition from interest rate benchmarks to alternative benchmark rates, and how the entity is managing that transition. Paragraphs BC105–BC109 of the Basis for Conclusions describe the Board's reasons for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose and why

A18 We concur with the disclosure objectives set out in paragraph 24I of IFRS 7 in the ED, however, we have some reservation on the detailed disclosures in paragraph 24J of IFRS 7 in the ED.

A19 Paragraph BC109 of the ED explains that the Board believes entities should provide the disclosures of the ED, when they apply the proposed amendments. In accordance with paragraph 7.2.38 of IFRS 9 and paragraph 108J of IAS 39 in the ED, entities are permitted, but not required to restate prior periods. Nevertheless, there is no relief from the proposed disclosure requirements in paragraphs 24I and 24J of IFRS 7 in comparative periods. In that regard, stakeholders have raised cost/benefit concerns about the quantitative disclosures required under paragraph 24J(b) for comparative periods. We request the IASB to consider whether comparative information should be provided, particularly when the amendments are not applied to comparative periods.

A20 We have also heard concerns around the disclosures proposed in paragraph 24J(c) of IFRS 7. It was noted that entities would be likely to produce standardised disclosures with little information content. We would recommend that the IASB assess whether this disclosure requirement could be amended to provide entity specific information on the benchmark reform that would be useful and if not, delete this disclosure.